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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of	)	
	)	
Implementation of Sections of	)	
the Cable Television Consumer	)	MM Docket No. 92-266
Protection and Competition Act	)	
of 1992	)	
	)	
Rate Regulation	)	

PETITION FOR RECONSIDERATION

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SUMMARY

The rate regulation provisions of the 1992 Cable Act, even if implemented properly, would impose severe constraints on the ability of the cable industry to invest in the programming and technology denied by consumers and needed to compete in the constantly changing video marketplace. The Commission's lengthy Report and Order, however, embodies a regulatory framework even more severe than what is mandated by the Act. In some respects, the rules are at odds with the explicit provisions of the Act; in others, the rules reflect policy determinations that are simply arbitrary and insupportable. In this petition, NCTA seeks reconsideration of the most egregious of these departures from what is required by the law and by sound policy. Reconsideration of at least these aspects is critical to ensure that the cable industry can invest in the future needs, interests and demands of consumers:

- <u>The decision to use the same benchmark approach, based on the rates of systems subject to "effective competition", to regulate basic and non-basic rates is contrary to the Act</u>.

  – Non-basic rates should only be deemed unreasonable if they substantially exceed the median rates charged by <u>all</u> systems -- not merely by systems subject to effective competition.

  – Non-basic rates should only be deemed unreasonable if they reflect excessive rate <u>increases</u> during the period of deregulation.

  – Non-basic rates should only be deemed unreasonable if the <u>combined</u>, per-channel rate for basic and non-basic tiers substantially exceeds the norm for all systems.

- <u>The Commission's benchmarks are, in any event, not suitable for regulating total revenues from basic and non-basic tiers</u>.

  – The Commission's sample of approximately 100 systems subject to "effective competition" does not provide an accurate measure of "competitive" overall rates to be used by benchmarks by the remaining 11,000 systems nationwide. Specifically, systems facing head-to-head competition and municipally owned systems are likely to charge rates that do not yield a reasonable profit.

- The benchmarks -- which contemplate an across-the-board 10% reduction of rates -- are based on the invalid assumption of a uniform 10% differential between rates of systems that do and do not face effective competition. In fact, the differential is not uniform; for systems with more than 5,000 subscribers, there are no significant differences between rates charged by "competitive" and "non-competitive" systems. Applying the Commission's benchmarks to overall basic and non-basic rates of systems with more than 5,000 subscribes will, therefore, force rates and revenues to 10 percent <u>below</u> what competitive systems charge -- and, therefore, below what is necessary to recover costs plus a reasonable profit.

- Because the per-channel benchmarks drop precipitously as the number of channels on a system increase, the benchmarks, if applied to non-basic tiers, would effectively preclude the ability of cable operators to add new, quality programming to those tiers.

- It is unfair and irrational not to allow systems whose rates for a particular tier are below the benchmark to increase their rates up to the benchmark. To prohibit such increases is to punish systems that did not increase rates excessively during the period of deregulation or whose timetables for upgrades or rebuilds may have lagged behind those of other systems.

• <u>Benchmarks should not, in any event, be based on *average* rates charged by systems subject to effective competition</u>.

- Half the systems subject to effective competition charge rates higher than the average -- but, by definition, those systems' rates are "competitive," too. Benchmarks should, in other words, be set at levels that reflect the <u>range</u> of rates charged by competitive systems. Only rates that exceed that range -- or, at least, that exceed rates near the outer edge of that range -- should be deemed unreasonable.

• <u>The rules should allow pass-throughs of a wider range of "external" costs</u>.

- Systems should be allowed to pass through costs of rebuilding and upgrading facilities. To require systems to submit to the delays and uncertainties of cost-of-service proceedings before recovering such costs is simply to discourage investment in rebuilds and upgrades. This is directly at odds with sound public policy, with the policy objectives of the Administration, and with the goals set forth in the Act.

- All increased programming costs should be treated as "external" costs. Specifically, there should be no exception for costs of programming owned in whole or in part by the cable system. The notion that cable programmers would raise their price to all buyers beyond the profit-maximizing price in order to enable their affiliated cable systems to evade rate regulation is implausible. In addition, there is no reason not to treat the initial costs of retransmission consent, which obviously were not included in the calculation of benchmark rates, as external costs.

• <u>Only equipment that is provided to basic-only subscribers -- and to basic subscribers who also buy per-channel and pay-per-view services without purchasing intermediate tiers -- should be required to be provided at "actual cost"</u>.

- The Commission's rules extend the "actual cost" requirement to virtually all cable equipment provided to all subscribers. Congress did not intend such a result and could easily have made clear such an intention if it did.

- By extending "actual costs" regulation to non-basic subscribers' equipment and by adopting a unitary benchmark scheme for basic and non-basic rates, the Commission's rates wrongly prevent systems form subsidizing actual- or below-cost provision of equipment, installations and additional outlets to basic subscribers with higher charges for the provision of such equipment to non-basic subscribers.

- In addition, the permissible rate of return on the sale or lease of equipment is too low. A rate higher than the 11.25 percent that is allowed to local exchange carriers is justified by the significantly higher risks of cable operators -- as we will show in the upcoming cost-of-service rulemaking proceeding.

• <u>The Commission should not authorize refunds in connection with basic rate regulation</u>. The Act explicitly authorizes such refunds only for non-basic rate regulation, and, by implication, prohibits such a requirement with respect to basic rates.

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PETITION FOR RECONSIDERATION

The National Cable Television Association, Inc. ("NCTA"), pursuant to Section 1.429 of the Commission's Rules, hereby petitions the Commission to reconsider its Report and Order in this proceeding.

INTRODUCTION

The Report and Order adopts rules implementing the rate regulation provisions of the Cable Television Consumer Protection and Competition Act of 1992. But the regulatory approach embodied by those rules departs substantially from the directives of the Act. Moreover, the manner in which the Commission has chosen to implement that regulatory approach is, in many respects, arbitrary and unreasonable.

Even if the Act were implemented properly, it would impose severe constraints on the cable industry and, notwithstanding its supposedly pro-consumer purposes, would prevent rather than promote the sorts of investments in programming and facilities that have made cable service more attractive to consumers in the past decade. But the Commission's rules, to the extent that they depart from the statute or implement it in an unreasonable manner, make an inevitably bad situation worse. By suppressing rates far below what is reasonable and what the Act requires, the Commission's "benchmark" approach goes beyond correcting any abuses that may have resulted from deregulation.

Indeed, it punishes the entire industry for those perceived abuses, and it does so in a manner that ultimately makes it impossible for cable operators, programmers and equipment suppliers to provide the level of cable service that consumers desire, demand and deserve.

I. **Subjecting Basic and Non-Basic Rates to the Same Competitive Benchmarks and Constraints Thwarts the Directives and Objectives of the Act.**

In its Report and Order, the Commission decided to adopt identical standards for determining whether basic rates are "reasonable" and for determining whether non-basic rates are "unreasonable." In both cases, the Commission will rely on "benchmarks" that are based upon the average rates charged by systems subject to effective competition. If a system's rates for basic or non-basic tiers of service are, on a per-channel basis, higher than the benchmark rate, then they will be subject to rate reductions.[1]

This unitary approach to regulating basic and non-basic tiers flies in the face of the clear language and intent of the Act. As a general matter of statutory construction, "[the] clear use of different terminology within a body of legislation is evidence of an intentional differentiation."[2] Congress meant for basic and non-basic tiers to be regulated differently, and to be subject to different standards of reasonableness and unreasonableness, respectively. Moreover, Congress intended that the reasonableness of a system's rates for non-basic tiers depend upon how much or how little the system charges for basic cable service. In any event, while benchmarks based upon the rates

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1 According to the Commission, the rates charged by systems that are subject to effective competition, as that term is defined in the Act, are, on average, apparently, ten percent less than the rates charged by systems that are not subject to effective competition. The benchmarks reflect an across-the-board ten percent reduction in average rates to take into account this differential. The Commission will require that, where rates for a particular tier are above the benchmark, they can be reduced to the benchmark or to ten percent less than the system's overall per-channel rate for basic and non-basic tiers as of September 30, 1992, whichever is the lesser reduction.

2 Lankford v. Law Enforcement Assistance Administration, 620 F.2d 35, 36 (4th Cir. 1980).

charged by systems subject to effective competition may be useful constraints to keep basic rates low and affordable, they are far too imperfect and imprecise for the purpose of regulating overall revenues from basic and non-basic tiers.

A. The Act Requires Different Regulatory Approaches and Standards for Basic and Non-Basic Tiers.

While adopting identical benchmark approaches -- and, indeed, identical per-channel benchmarks -- for regulating basic and non-basic tier rates, the Commission acknowledges that the Act's provisions regarding basic and non-basic rates contain completely different language. The Commission's view, however, is that this

> simply reflects the different procedural regulatory schemes Congress adopted from protecting consumers from excessive rates for basic and for cable programming services rather than different substantive standards.[3]

This interpretation strains credulity; it is impossible not to conclude, from the statutory language and from the legislative history, that Congress intended that the Commission apply different substantive and procedural standards to basic and non-basic rates.

With respect to basic rate regulation, Section 623(b) specifies exactly what the objective of the Commission's regulations and standards is to be:

> Such regulations shall be designed to achieve the goal of protecting subscribers of any cable system that is not subject to effective competition from rates for the basic service tier that exceed the rates that would be charged for the basic service tier, if such cable system were subject to effective competition.[4]

Section 623(c), which sets forth the framework and standards for regulating non-basic "cable programming services" contains no parallel directive to constrain non-basic tier rates to "competitive" levels. It requires the Commission only to establish criteria for identifying, on a case-by-case basis, rates that are "unreasonable."[5]

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[3] Report and Order, ¶ 389.

[4] Sec. 623(b)(1) (emphasis added).

[5] Sec. 623(c)(1)(A).

Sections 623(b) and 623(c) both set forth lists of factors that the Commission is to consider in establishing standards and regulations for regulating basic and non-basic rates -- and these lists are revealingly different from each other.[6] For example, in establishing regulations for basic rates, the Commission is to take into account "the rates for cable systems, if any, that are subject to effective competition" -- and those are the only rates that are to be considered. The Commission is similarly supposed to consider the rates of systems subject to effective competition in establishing standards for non-basic rate regulation -- but, here, the Commission is also supposed to consider

> the rates for similarly situated cable systems offering comparable cable programming services, taking into account similarities in facilities, regulatory and governmental costs, the number of subscribers, and other relevant factors.[7]

In other words, whether or not a system's non-basic rates are "unreasonable" should depend, at least in part, on how those rates compare to the rates charged by similar systems that are not subject to effective competition, as well as how they compare to the rates of systems subject to effective competition.

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6 When the two lists of factors to be considered are viewed side-by-side, it is apparent that Congress intended two different regulatory approaches. See Table 1.

7 Sec. 623(c)(2)(A).

TABLE 1

BASIC RATES **[Sec. 623(b)]**	**NON-BASIC RATES** **[Sec. 623(c)]**
[The Commission] (A) shall seek to reduce the administrative burdens on subscribes, cable operators, franchising authorities, and the Commission; (B) may adopt formulas or other mechanisms and procedures in complying with the requirements of subparagraph (A); and (C) shall take into account the following factors: (i) the rates for cable systems, if any, that are subject to effective competition; (ii) the direct costs (if any) of obtaining, transmitting, and otherwise providing signals carried on the basic service tier, including signals and services carried on the basic service tier pursuant to paragraph (7)(B), and changes in such costs; (iii) only such portion of the joint and common costs (if any) of obtaining, transmitting, and otherwise providing such signals as is determined, in accordance with regulations prescribed by the Commission, to be reasonably and properly allocable to the basic service tier, and changes in such costs; (iv) the revenues (if any) received by a cable operator from advertising from programming that is carried as part of the basic service tier or from other consideration obtained in connection with the basic service tier; (v) the reasonably and properly allocable portion of any amount assessed as a franchise fee, tax or charge of any kind imposed by any State or local authority on the transactions between cable operators and cable subscribers or any other fee, tax, or assessment of general applicability imposed by a governmental entity applied against cable operators or cable subscribers; (vi) any amount required, in accordance with paragraph (4) to satisfy franchise requirements to support public, educational, or governmental channels or the use of such channels or any other services required under the franchise; and (vii) a reasonable profit, as defined by the Commission consistent with the Commission's *obligations to subscribers under paragraph (1).*	[T]he Commission, shall consider, among other factors (A) the rates for similarly situated cable systems offering comparable cable programming services, taking into account similarities in facilities, regulatory and governmental costs, the number of subscribers, and other relevant factors; (B) the rates for cable systems, if any, that are subject to effective competition; (C) *the history of the rates for cable programming* services of the system, including the relationship of such *rates to changes in general consumer prices;* (D) the rates, as a whole, for all the cable programming, cable equipment, and cable services provided by the system, other than programming provided on a per channel or per program basis; (E) capital and operating costs of the cable system, including the quality and costs of the customer service provided by the cable system; and (F) the revenues (if any) received by a cable operator from advertising from programming that is carried as part of the service for which a rate is being established, and changes in such revenues, or from other consideration obtained in connection with the cable programming services concerned.

Also, the factors to be considered in connection with non-basic rate regulation include "the <u>history</u> of the rates for cable programming services of the system, including the relationship of such rates to changes in general consumer prices."[8] <u>No</u> such factor is to be considered in connection with basic rate regulation.

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[8] Sec. 623(c)(2)(C).

Another difference in the lists of statutory factors is that, in regulating non-basic rates, the Commission is to consider

> the rates, as a whole, for all the cable programming, cable equipment, and cable services provided by the system, other than programming provided on a per channel or per program basis.[9]

What this means is that whether a system's non-basic rates are unreasonable depends, to some extent, on what the system charges for basic service. Basic rates are not subject to this provision. Their reasonableness depends solely on whether they approximate rates that would be charged if the system were subject to effective competition, regardless of what the system charges for non-basic tiers.

What these distinctions illustrate is that the regulation of non-basic rates has a very different purpose from the regulation of basic rates. While "reasonable" basic rates are those that approximate what would be charged if a system were subject to effective competition, non-basic rates are not to be deemed "unreasonable" simply because they exceed the rates of systems subject to effective competition. The Act mandates a more flexible regulatory approach for non-basic rates:

First, non-basic rates should only be deemed unreasonable if they not only exceed the rates charged by systems subject to effective competition but also exceed, at least to some significant degree, the rates charged by similarly situated systems not subject to effective competition. The Commission rejects the view that, to be unreasonable, rates must "egregiously" exceed the norm.[10] But while there may be room to argue about how far in excess of the norm for similarly situated systems rates may rise before being deemed unreasonable, there is no doubt that rates must, at least, be in excess of the norm to be deemed unreasonable. Indeed, the legislative history specifically states that only "a

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9 Sec. 623(c)(2)(D).

10 Id., ¶ 388.

minority of cable operators have . . . unreasonably raised rates."[11] Yet, the Commission, by pegging the unreasonableness of non-basic rates to rates charged by systems subject to effective competition, has recognized that, under this standard, the overall rates of most systems will be judged unreasonable and will be reduced.[12] There is simply no basis for ignoring an obvious statutory mandate, confirmed by the legislative history, to look to rates charged by other systems not subject to effective competition in assessing whether a system's non-basic rates are unreasonable.

Second, non-basic rates should only be deemed unreasonable if they reflect excessive rate increases during the period of deregulation. The fact that some operators "unreasonably raised rates" after deregulation and that "[i]n some cases . . . those rate increases have been egregious"[13] was what concerned Congress, and it is this concern that is reflected in the statutory requirement that, in determining whether non-basic rates are unreasonable, the Commission consider the system's history of rates with respect to inflation. In other words, wholly apart from the extent to which a system's rates exceed the norm for similarly situated systems, those rates should not be deemed unreasonable if they have not increased unreasonably since deregulation. At the very least, the rules should provide that, whatever other benchmarks may be established, a system whose overall per-channel rates have not increased by more than the rate of inflation since deregulation will not be deemed to have rates for non-basic "cable programming services" that are unreasonable.

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11 Report of Committee of Energy and Commerce of the House of Representatives, H.R. Rep No. 92-628, 102d Cong., 2d Sess. 68 (1992) (emphasis added).

12 "These reductions could be required of up to three-quarters of all regulated cable systems serving approximately three-quarters of the country's cable subscribers." Report and Order, ¶ 15 (emphasis added).

13 Id., (emphasis added).

Third, in assessing the reasonableness of non-basic rates, what should matter is the combined, per-channel rate for basic service and for non-basic cable programming services. Only if that rate exceeds the norm for similarly situated systems by a sufficiently substantial amount (and if it has increased by an amount sufficiently in excess of inflation since deregulation) should the system's non-basic rates be deemed unreasonable.

The Commission has not only ignored this factor; it has adopted quite the opposite approach. The rules subject each tier to the same competitive benchmark. If a system's rates for a non-basic tier are above the benchmark, those rates will be deemed unreasonable, even if the system's rates for basic service are far below the benchmark. The result of this approach is that cable systems have no incentive or ability to subsidize a basic tier priced below the benchmark with more expensive non-basic tiers priced above the benchmark. Since non-basic tier rates that are above the benchmark will, in any event, be reduced, systems with such rates but with basic rates below the benchmark will have no choice but to increase their basic rates up to or closer to[14] the benchmark.

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[14] In a particularly perverse twist, the rules not only require systems to reduce non-basic tier rates that are above the benchmark even where basic rates are correspondingly below the benchmark; they also prevent cable systems, once they are subject to regulation, from raising their basic rates up to the benchmark levels, even though those levels have been determined to be "reasonable." Instead, such systems are limited to annual increases that reflect inflation and certain identifiable "external" costs.

During the freeze period that ends on November 15, 1993, cable systems may adjust their tiers and rates on a revenue-neutral basis to bring each tier's rates into compliance with the benchmarks. But a system whose basic rates are above the benchmark will not, even during this transition period, be permitted to bring its total rates up to benchmark levels -- and will forever be constrained to rates that are below the rates that can be charged by systems whose rates for all tiers, when the freeze took effect, were above benchmark levels. There is no sound reason for punishing those systems that most clearly did not raise rates unreasonably during deregulation, and those whose timetables for rebuilds and other system expenditures may have lagged behind those of other systems. The Commission should for the reason described in this section, assess the reasonableness of non-basic tier rates in terms of the overall

The regulatory framework set forth in the statute suggests that provision of a low-priced basic tier, subsidized by more flexibly regulated non-basic tiers, was a principal objective of Congress. Indeed, Congress specifically authorized, if not encouraged, the Commission to adopt rules that promoted such a result. Congress clearly did not intend that basic rates subsidize non-basic rates,[15] but it specifically contemplated subsidies going in the other direction. And it told the Commission that it had authority to "decide as a policy matter to keep the rates for basic cable service as low as possible."[16]

The Commission has rejected this invitation and has instead required each tier to meet the same benchmark, on the policy grounds that such an approach is "tier neutral."[17]

B. Benchmarks Based on Rates Charged By Systems Subject to Effective Competition Are Too Crude and Inaccurate a Tool To Be Used in Regulating Overall Revenues from Basic and Non-Basic Tiers.

Benchmarks of the sort adopted by the Commission -- based on a regression analysis to determine the effect on rates of effective competition -- are a useful and suitable device for regulating basic service rates for the purposes contemplated by the Act. Indeed, NCTA proposed just such an approach in its comments.[18] But benchmarks based on the rates of only approximately 100 systems that meet the Act's definition of "effective competition" -- 1% of all cable systems nationwide -- are an imperfect, imprecise and inherently arbitrary measure of "competitive" rates. This imprecision and arbitrariness may be acceptable where the objective is simply to ensure a low-priced basic service -- and where non-basic rates are regulated pursuant to a less stringent and more flexible standard designed only to rein in outliers whose overall rates substantially exceed the median. It is wholly unacceptable, however, if the benchmarks are to be applied to basic and non-basic tiers, thereby regulating most of a system's overall revenues

1. The Commission's sample of "competitive" systems does not <u>provide an accurate measure of "competitive" rates.</u>

Alarm bells should immediately sound at the notion that the entire cable industry's rates, revenues, and ability to borrow and invest will be determined on the basis of a sample of only approximately 100 cable systems. The sample, consisting of only 1% of the overall universe of systems is not, however, inherently too small to draw statistically significant inferences where sampling is scientifically designed to ensure that the systems chosen are representative of the universe. But the sample chosen was not representative of a broader universe; it was a self-contained universe of systems that, by definition, are different from most cable systems. The systems that meet the Act's definition of systems facing "effective competition" are likely, for various reasons, to charge rates that are lower than truly "competitive" rates. And, in any event, the survey methodology -- which relied on the unchecked mail response of systems to a confusing and ambiguous questionnaire -- as not sufficiently scientific to have produced responses that accurately reflect what even the universe of systems defined by the Act to be subject to effective competition actually charge.

Most of the systems in the sample face "effective competition" because there are other cable systems providing services in their franchise areas. As we explained in our comments in this proceeding, benchmark rates based on such "overbuild" situations are not likely to be "competitive":

> Short-term price wars are common in cable overbuild situations. In part, this is because the new entrant in the marketplace often has no intention of investing in long-term competition but only seeks ultimately to be purchased by the more established competitor. There is a long tradition of such attempts at "greenmail" by cable overbuilders, and its effect is to suppress prices to levels that could not over the long term, support cable operations and, in particular, could not support the investment in

> maintenance, programming and technology that is necessary to the sustenance of cable television.[19]

Moreover, the Commission's set of systems subject to effective competition includes a number of municipally owned systems (which are defined by the Act to be subject to effective competition) as well as some systems that compete head-to-head with municipally owned systems. These system's rates are extremely unlikely to cover costs plus a reasonable profit, because municipally owned systems typically are subsidized by the municipality and are not intended to earn profits.

A review of some of these systems indicates that, in fact, they are not charging rates that allow them to recover a reasonable profit. Attached to this petition is an economic analysis of the rates, revenues and profitability of the municipally owned system and the privately owned system with which it competes in Paragould, Arkansas.[20] That analysis

> indicates that Paragould City Cable is indeed losing money and that Paragould's municipally owned cable system will continue to incur significant financial losses indefinitely, so long as two competing cable systems are serving Paragould residents. Paragould City Cable will lose over $3,000,000 from 1997 to 2001 due to charging rates for cable services that are non-compensatory -- City Cable's rates are below cost.[21]

These losses are sustainable because the system is subsidized by the city:

> The City of Paragould recently imposed a $60 per home tax on all Paragould residents to subsidize the City's cable system and raise funds for interest payments.

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19 NCTA Comments at 18-19 (footnote omitted). The Commission cites no evidence in the record to refute this point, and, indeed, there is none. See Report and Order, ¶ 200.

20 Malarkey Taylor Associates, Inc., Economic Analysis of Municipal Overbuild Cable System in Paragould, Arkansas (1993).

21 Id. at 2.

> Moreover the financial results shown above understate Paragould City Cable's actual losses to the extent that Paragould Light and Water Commission subsidizes the cable system's operations by providing shared resources and personnel at no cost. City officials have reporated such cross-subsidization.[22]

Not surprisingly, the privately owned and unsubsidized system that is competing with the municipally owned system is incurring even larger losses. While the municipally owned system "is likely to incur over $3,000,000 of losses in the next ten years, . . . Paragould Cablevision is likely to incur over $10,000,000 of losses in the next ten years."[23] Yet both these systems are among the 100 systems whose rates will, under the Commission's approach, constrain the revenues of the entire cable industry.

Other municipally owned systems in the sample seem also to be charging rates that do not yield reasonable profits. For example, in Elbow Lake, Minnesota, a municipally owned system presented a financial analysis that showed that the system had an accumulated loss, after 13 months of operation, of $33,810 -- not including accrued interest or its debt service of $37,600. The city had provided subsidies of more than $71,000 per year, amounting to more than $220 per subscriber per year. The system's projections indicated that to break even in 1993 and 194, it would need to double its rates, from $14.95 for 25 channels to $29.30. Yet it is the existing rate of $14.95 that is included in the Commission's calculation of the difference between systems that do and do not face "effective competition."

Similar situations exist in Glasgow, Kentucky and Coleraine, Minnesota. In Glasgow, the municipal system's rate of $13.50 for 48 channels is effectively subsidized through the shared use of municipal facilities for telephone, data, and cable services. Even with this subsidy, recent financial statements show a net loss. In Coleraine, where 38 channels are available for $15, the city subsidizes the system by providing capital

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22 Id. at 3.

23 Id. at 4.

equipment and city employees at no charge or at partial charge, and by issuing a bond for capital investment, on which it pays the annual $9,000 out of city revenues. These subsidies outweigh the $2,300 surplus reporated in a recent statement of receipts and disbursements -- a statement that, in any event, reports no depreciation expense or local property taxes.

These examples are illustrative of the non-renumerative rates charged by municipally owned systems and systems facing overbuild competition from municipally owned systems and others. In addition, the Commission's sample is skewed by "competitive" systems that are in no way representative of the majority of "non-competitive" systems whose rates will be constrained by the benchmarks. Nineteen systems -- 17% of the sample -- have fewer than 100 subscribers in the franchise area; several of these have fewer than 20 subscribers.

This is, in short, not a meaningful sample from which benchmarks that govern overall rates and revenues can be calculated. Benchmarks drawn from such data might provide a crude tool for ensuring a low-priced basic service. But they are utterly invalid as a measure of "competitive" rates and, if applied to basic and non-basic tiers, would pose a severe threat to the continued growth and profitability of the cable industry. For the Commission to rely on any benchmark system to establish overall rates, it must assure that such a syste actually earns reasonable profit. The FCC undertake such an analysis (since no one party including NCTA can provide this data) or not rely on such systems solely to detemine overall rates.

2. The benchmarks are based on the invalid assumption of a uniform competitive differential.

Even if the rates of the systems in the Commission's sample were truly "competitive," the Commission's method of calculating benchmarks based on those systems would still yield grossly inaccurate results. Having found that, on average, the rates of systems subject to effective competition are ten percent lower than the rates of systems not subject to effective competition, the Commission included in its benchmark formula a ten percent downward adjustment of the rates of all systems in all cells of its benchmark tables to reflect the supposed effect of competition. This adjustment assumes that the ten percent differential is constant among systems of all types and sizes. But, as the attached report of Economists Incorporated[24] demonstrates, this turns out to be an invalid assumption.

In fact, there are significant differences between systems that do and do not face effective competition only <u>among systems with fewer than 5,000 subscribers</u>. For systems with more than 5,000 subscribers, there are no statistically significant differences between the rates charged by systems that face effective competition and the rates charged by systems that do not.

Therefore, applying a 10 percent competitive adjustment across the board completely misses the mark. For systems with more than 5,000 subscribers, such a 10 percent reduction in rates is wholly unwarranted and will drive average rates to 10 percent below what systems subject to effective competition charge. Systems subject to effective

This flaw in the Commission's benchmark approach would not be fatal if, as the Act contemplates, benchmarks based on rates charged by systems subject to effective competition were only applied to basic rates. In that case, the effect would be to lower basic rates to levels that were probably lower than what would be charged in a stable, long-term competitive marketplace. But the overall effect on cable operators, and on the development of programming and technology, would be mitigated to the extent that overall rates for basic and non-basic tiers combined were subjected to a less stringent standard of reasonableness that allowed most operators to recover a reasonable overall profit, notwithstanding the rigid constraints on their basic rates. If, however, total rates and revenues from basic and non-basic tiers are subjected to inherently flawed benchmarks, there is no safety valve -- no opportunity to recover any shortfall in revenues that such benchmarks might impose.

3. The benchmarks prevent operators from adding new programming to their basic and non-basic tiers.

Finally, the Commission's benchmarks are particularly unsuitable for regulating non-basic tiers because they unintentionally but effectively preclude the ability of cable operators to add new, quality programming to such tiers. The benchmarks are based on a static analysis of the per-channel rates charged by systems subject to effective competition. Not surprisingly, the per-channel rates decline as the number of channels on a system increase. But they decline so precipitously that systems that increase their channel capacity will not be allowed to charge enough to pay for programming to fill their new channels.

For example, the benchmark tables allow a 10,000-subscriber system with 30 channels, of which 15 are satellite-delivered cable services, to charge $0.673 per channel -- or a total of $20.19. But if that system were to upgrade its plant and offer 30 additional channels of satellite services, its maximum allowable per-channel rate would decline to $0.406, and it could charge a total of $24.36. In other words, it could obtain only $4.17 --

or less than $0.14 per channel -- for the 30 new program services that it added. This amount would not cover the costs of quality programming, much less the costs of upgrading the system's plant to enable the provision of such programming. As a result, operators would have no incentive to add new program networks to their tiers, and the development of new programming and new technology for expanding channel capacity would be discouraged.

Again, this problem would be minimized if the benchmarks were used only to regulate basic rates. Systems might be discouraged from adding a large number of satellite services to their basic tiers -- but this would, at least, ensure that basic rates remained not only reasonable on a per-channel basis but also affordable overall. Meanwhile, systems would have no disincentive at all to add new program services on non-basic tiers, where allowable per-channel rates would not decline, as channels were added, to levels that would not allow recovery of the costs of such program services.

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For all these reasons, the Commission should reconsider its decision to impose a unitary benchmark scheme on both basic and non-basic tiers. If there are to be benchmarks based on rates charged by systems subject to effective competition, those benchmarks should be used only to regulate <u>basic</u> rates. Non-basic "cable programming services" should be subject to a more flexible standard of what is "unreasonable" -- a standard that reins in only those systems whose overall rates for basic and non-basic tiers substantially exceed the median rates charged by all systems, whether subject to effective competition or not.

II. If Benchmarks Are To Be Based on Rates Charged by Systems Subject to Effective Competition, It Makes no Sense To Use the <u>Average</u> Rates Charged <u>by Such Systems.</u>

In Part I, <u>supra</u>, we showed why, as a matter of law and as a matter of policy, the Commission should not use a unitary benchmark scheme based on rates charged by systems subject to effective competition to regulate both basic and non-basic rates. While such benchmarks might be a useful tool for ensuring that basic rates are low and widely affordable, using them to regulate overall revenues from basic and non-basic tiers would have severe adverse effects on the viability of cable operators and on the development of cable programming and technology.

The problem inherent in applying benchmarks to overall rates are, however, compounded by the Commission's decision to peg its benchmarks to the average rates

What is clearly irrational, in any event, is to treat rates that exceed what only half the competitive systems charge -- and, therefore, are also below what half the competitive systems charge -- as unreasonable. As discussed in Part I, many of those "competitive" systems are already, for various reasons likely to be charging rates that are too low to provide a reasonable profit. If the Commission persists in applying its "competitive" benchmarks to rates for non-basic cable programming services, it becomes imperative -- not only as a matter of logic but also as a matter of sound public policy -- that the benchmarks be based not on the average rates of competitive systems but on rates that exceed what most competitive systems charge.

III. The Rates Should Allow Systems to Pass Through a Wider Range of

A. Costs of Rebuilding and Upgrading Facilities.

The Commission sets forth several reasons for deciding that it "should not give external treatment to costs of system improvements."[25] First, "[s]uch expenditures are likely to be significant and if automatically passed through could lead to substantially increased rates."[26] This may, of course, be true -- but it is irrelevant. The question is whether, given that simply passing through the costs of system improvements will not provide operators with any supracompetitive profits, the Commission has any independent reason for discouraging or encouraging such improvements. It is difficult to understand why the Commission would not want affirmatively to encourage technological improvements and system upgrades. And it is impossible to understand why the Commission would want to discourage such improvements. Such improvements should be presumptively in the public interest. Indeed, it is an explicit goal of the Act to "ensure that cable operators continue to expand, where economically justified, their capacity and the programs offered over their cable systems."[27] But by allowing cable operators to recover the costs of such improvements only after the delays and uncertainties inherent in a cost-of-service showing, the Commission has essentially decided that system improvements are presumptively not in the public interest. That is a completely inexplicable decision.

But the Commission apparently intends not only to permit system upgrades to be held hostage pending cost-of-service proceedings, but also to allow franchising authorities to "weigh the costs and benefits of network improvements."[28] In other words,

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[25] Report and Order, ¶ 256 n.608.

[26] Id.

[27] Act, Sec. 2(b)(3).

[28] Id.

the Commission intends to allow franchising authorities not only to determine whether a system's increased rates are justified by corresponding increased costs from a system upgrade but also to determine whether the system upgrade is desirable and ought to be allowed in the first place.

Nothing in the Act -- and, in particular, none of the statutory factors to be considered by the Commission in establishing rate regulation standards -- suggests any such role for franchising authorities. The reason why Congress decided to reimpose rate regulation on cable systems was not because, after deregulation took effect in 1986, cable operators invested excessively in programming and system upgrades. To the contrary, Congress acknowledged that deregulation had the positive, pro-competitive effect of fostering increased expenditures on programming and equipment -- which made cable service more attractive to consumers.[29] Regulation was reimposed, despite this positive result, because of a belief that some cable operators were increasing rates in excess of what they spent on improved programming and facilities. The point of reregulation was to eliminate those perceived excess profits, not to curtail perceived excess expenditures. To the extent that, by refusing to allow pass-throughs for system upgrades, the Commission intends to return to franchising authorities the right to approve or disapprove expenditures in such upgrades, it is exceeding its statutory mandate and reversing what Congress viewed as one of the beneficial aspects of the 1984 Act.[30] The Commission

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[29] See, e.g., Report of Senate Committee on Commerce, Science and Transportation, S.Rep. No. 102-92, 102d Cong., 1st Sess. 3 (1991).

[30] The Commission also contends that "[a]dditionally, system improvements typically increase channel capacity, which will increase the total revenues per subscriber achievable, even under the benchmark formula, or reduce maintenance or other service expenses." Report and Order, at 256 n.608. Nobody is seeking to pass through the total expenses of system upgrades on top of the rate increases that are allowed simply as the result of providing more channels at the same per-channel rate. But to the extent that the costs of the system upgrade and of the programming provided over those new channels exceed the additional per-channel revenues authorized by the benchmark tables, cable systems should be allowed to pass-through